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PRIVATE WEALTH

Investment Matters

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BESPOKE
FINANCIAL EXPERTISE
TO MAKE THE RIGHT
MOVES, MORE OFTEN.

EQUITY OUTLOOK FROM CIO'S DESK

It was back to the outperformance of developed markets (DMs) versus their emerging market (EMs) counterparts after a pause in March. The MSCI AC World Index was +3.9% in April versus +2.8% for the MSCI EM Index.

With the US FED saying that a) downside risks to growth in USA remained and that they would keep interest rates low for the foreseeable future and b) that they would not seek an early end to QE2 (but it *will* end and the chances of a QE3 seem remote at best), we saw a flood of US$5.6bn flow into US equities in the last week of April. US markets made fresh 2011 highs and the Dow ended +4% for the month.

India underperformed the rest of Asia, after two consecutive months of outperformance. In April, the MSCI India Index fell -1.1%, while the MSCI AC Asia ex Japan Index was up +3.6%. Asia ex Japan saw its fifth consecutive week of inflows.

After five consecutive months of underperformance, however, the broad markets in India outperformed the narrow market. Breadth was at a 15-month high. The Small Cap and Mid-Cap indices were up +6.6% and +3.2%, respectively, while the Nifty was down -1.4%. The BSE500 was marginally down at -0.1% for the month. Market activity disappointed and cash market volumes fell to a 26-month low of US$64mn for the month of April. Volumes in the derivatives segment were at US$530bn, a four-month low.

While FII flows were positive for the month, they were net sellers during the last week of the month. Despite this selling by FIIs, their net flows into the cash market came to +US$1.57bn, resulting in YTD flows turning positive, at +US$916mn. Domestic institutions became net sellers during the month and sold -US$106mn of equities in the cash market. Overall, YTD they have invested +US$346mn in the Indian equity markets.

During the early part of the month, we saw the ECB become cautious on inflation, resulting in a rate hike of 25bps. This was despite the mounting debt crisis in banks in Ireland, Portugal and Greece. We saw further tightening by China, Poland and Russia. We saw the dollar index fall -3.9% and the euro appreciate +4.6% versus the US dollar, during the month. The rupee fell to a 15-month (since Jan 2010) low versus the euro, but appreciated to a 30-month (since Sep 2008) high versus the US dollar.

Crude and commodity prices remain elevated. This poses macro risks for India: upside risks to inflation, CAD and fiscal deficit, as India is a net importer of these inputs. With an end to Osama, it is widely expected that the 'pro-democracy' activists in the MENA region will intensify their efforts to dislodge autocratic governments who now have less of a reason to stay in power (to fight Al Qaeda). We thus expect crude prices to remain elevated for an extended period.

March inflation surprised negatively and came in at 8.98%, versus 8.3% in February. While the high base effect will help curb inflation, going forward, it is still expected to remain at high levels for the next few months. Prices of petrol and diesel will be hiked any time now, as state elections (in five states) come to an end on 11 May. The RBI, India's central banker, has now turned hawkish and hiked policy rates by 50bps to 7.25%, at its policy meeting on 03 May. This is the first 50bps hike (nine rate hikes now, including this one) since the rate hike campaign started in January 2010 and policy rates (repo rate) have been increased by 250bps from 4.75% to 7.25%. It is largely expected that RBI will continue to increase rates another 75bps during the year to 8%. This will impact growth further, which is already showing signs of slowing down.

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It is pertinent to note that in the last tightening cycle campaign, that ran from late 2005 to mid-2008, the central bank increased rates 10 times (with the last two increases being 50bps each, in quick succession) from 6% to 9%, so by 300bps. This was subsequently cut during late 2008 to 2009-end, to 4.75% (so by -425bps), during the global financial meltdown.

The March quarter (4QFY11) earnings season has commenced and 9 of the 30 Sensex companies have reported so far, with 5 beating estimates. However, margin compression is now showing up. While revenues are up +26% YoY (and have beaten estimates), earnings growth is +23% YoY (300bps lower than estimates). For the broad market, 254 companies have reported. These represent 26% of India's market cap. Revenues and earnings have both beaten estimates, with +27% YoY growth for each. It should be noted that Sensex companies, for the first nine months of FY11, delivered 23% earnings growth and 4Q (March) earnings are expected to moderate to 17% (broad market growth is expected to be lower than this).

We expect GDP growth to slow down from 8.5%, to around 7.5-8%, subject to a normal monsoon. The first estimate of south-west monsoons indicates a normal monsoon this year, with rainfall for the country as a whole expected to be around 98% of the long-term average of 893mm. Consensus estimates for Sensex earnings growth for FY12 are at 18.6%, valuing the Sensex (19,136) at P/E 14.8x, at around its long-term average. We see downside risks to earnings, largely driven by margin compression. We therefore see limited upside to the narrow market. We, however, continue to see bottom-up opportunities in the broad market.

Exports continue to surprise positively, led by recovery in DM economies. For March, exports rose ~44% YoY to US$29.1bn. For the fiscal year ending March 2011, India's exports grew ~37% YoY to US$245.9bn. This was led by a 85% YoY surge in engineering exports to US$60bn.

Strategic investors continue to be bullish on India. During April, we saw Merck, one of the largest US pharmaceutical companies, tie up (in a JV) with India's Sun Pharma (SUNP IN). Merck will use Sun's expertise to develop and manufacture branded generics at a lower cost in India, while it focuses on its strength of marketing these branded generic drugs in other emerging markets.

It should be noted that Indians hold large amounts of physical gold (it's a cultural thing) and including the 5,700 tonnes acquired over the past eight years, the value of these gold holdings is now at US$1 trillion or 70% of India's GDP. This 'wealth effect' is partially driving domestic consumption across both urban and rural India.

YTD India is the now third worst (out of twenty-one) performing EMs. This, indeed, represents an opportunity for the long-term investor.

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DEBT OUTLOOK

Key highlights of RBI monetary-policy review meeting, held on 03 May 2011:

- Repo rate hiked by 50bps to 7.25%
- Reverse repo rate pegged at 100bps below repo rate
- Introduces new Marginal Standing Facility (MSF) for borrowing by scheduled commercial banks from RBI; pegged at 100bps above repo rate.
- Accordingly, the reverse repo rate hiked to 6.25% and MSF rate is at 8.25%
- Savings bank deposit rate hiked to 4.00% from 3.50%
- No change in CRR or bank rate.
- Operating target of policy to be weighted average call money rate

RBI's main objective is clearly directed to tame inflation. The monetary policy's stance was to maintain an interest rate environment that moderates inflation and anchors inflation expectations. It also aims to foster an environment of price stability that is conducive to sustaining growth in the medium-term, coupled with financial stability. The objective is to manage liquidity to ensure that it remains broadly balanced, with neither a large surplus diluting monetary transmission nor a large deficit choking fund flows.

Market reaction was an immediate rise in 3-month CD rates by 25-30bps to 9.25%, from 8.95% earlier and 10-year government bond yields rose by 5-6bps. Going forward, the yield curve will continue to flatten on further rate-hike expectations and 3-month CD rates are expected to drift to 9.50–9.75% levels by May-end. Government bonds will remain under pressure from the supply side in May and are expected to move in a broad range of 8.15-8.30% in the near future.

There has been a significant shift in the liquidity situation in the banking system. The government cash balances have moved from a surplus of close to Rs90,000 crores kept with the RBI, to borrowings of Rs37,000 crores. The huge amount of government spending in April has resulted in LAF borrowing coming down from an average of Rs80,000 crores in March, to Rs35,000 crores at the end of April. The improvement in the liquidity situation has resulted in the short-term money-market rates in the 3-month tenure coming down by around 170bps from the March levels. We expect the liquidity situation to start tightening, going forward, driven by monetary tightening, a higher supply of T-bills and cash management bills and the scheduled G-Sec auctions.

Liquid funds and Ultra Short-Term funds continue to be attractive as carry-yield portfolios, as they will benefit from assets re-pricing and liquidity. Income from short-term funds will offer attractive yields to investors, as the fund's investments are in a duration band of six months to one-and-half years, but investors should have a minimum horizon of six months to one year. FMP's will remain an attractive investment option because of the rise in short-term yields.

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